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Options of State and Local Governments For Dealing With Shfits And Fiscal Stress: A Midwest Perspective

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Abstract
We live in a world of change. Nothing stays the sane forever. Communities and institutions are born. Some group and continue to group. Some nay experience decline. Some nay even die. Fiscal stress may' occur during the growth phase if the demand for community services expands faster than the capacity to deliver the services. However a different kind of fiscal stress occurs when the community's economic base erodes due to structural change in nature or declining industries like agriculture, mining, petroleum or labor-intensive manufacturing. This symposium is concerned more with the last type of stress.

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OPTIONS OF STATE AND LOCAL GOVERNMENTS FOR DEALING WITH SHIFTS AND FISCAL STRESS: A MIDWEST PERSPECTIVE *

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OPTIONS OF STATE AND LOCAL GOVERNMENTS FOR DEALING WITH SHIFTS AND FISCAL STRESS: A MIDWEST PERSPECTIVE

We live in a world of change. Nothing stays the same forever. Communities and institutions are born. Some grow and continue to grow. Some may experience decline. Some may even die.

Fiscal stress may occur during the growth phase if the demand for community services expands faster than the capacity to deliver the services. However a different kind of fiscal stress occurs when the community's economic base erodes due to structural change in mature or declining industries like agriculture, mining, petroleum or labor-intensive manufacturing. This symposium is concerned more with the last type of stress.

Fiscal stress may be accute if it is due to a major plant closing. Stress may be transitional if it is due to changes in intergovernmental aid. Industry-wide stress may be temporary if it is due to a business cycle or global economic shock. However, fiscal stress may be chronic and permanent if it is due to shifts in policy, structural attrition, or global competitiveness.

As a result, it is appropriate that we ask some of the most basic questions about options of state and local government for dealing with fiscal stress. Not only are there some perceived short-term policy transitions to be made but also there are many fundamental changes occurring in the underlying economic environment and structure of the midwest economy. Many of these underlying changes are redefining the "economic reasons for being" in many midwestern communities.

RECENT TRANSITIONAL FORCES CONTRIBUTING TO FISCAL STRESS

All communities must have an "economic reason for being." If that reason disappears due to global competition and exchange rates, then the community must either adapt or find additional reasons for existence or it will likely face decline.

Various parts of the midwest economy have been hit hard by the global competition in agriculture, mining, petroleum and labor-intensive manufacturing. It is a sign of the times when a recent study identified that government and retirement were the two sectors providing the most growth in U.S. nonmetro counties in the first half of the 1980s (Henry, Drabenstott and Gibson).

Some Midwestern communities have experienced measures of economic recovery during the past couple of years due to an improved agricultural economy. However, the record livestock price margins and program payments that provided the tranfusion are no sure bet for lasting into the next decade.

In addition, the Tax Reform Act of 1986 is providing an income tax windfall to some state coffers like Iowa and Kansas. But there is no guarantee that the windfalls will be used to reduce fiscal stress of local governments. And, other midwestern states like Nebraska and North Dakota are expected to receive a major revenue loss due to the change (Durst and Reeder).

In fact, many local government units may now be experiencing more fiscal stress than was present in the first half of the 1980s. This may be partly due to local government's reliance on property taxes and the lag in property tax assessments (Ervin, Chicoine and Nolte). In addition, cities and counties have been affected by the phasing out of federal revenue sharing. However, other dramatic underlying factors may be involved too.

THE GLOBAL ECONOMY AND MIDWESTERN COMMUNITIES

Several global forces are affecting our traditional thinking about the way our world economy works and the role of the Midwestern communities (Schuh; Drucker):

(1) Raw materials have come "uncoupled" from the industrial economy. In other words, just because a nation or a community has raw materials does not mean that it will be able to develop or maintain an industrial economy.

(2) The industrial economy has come "uncoupled" from employment. This means that increases in productivity, technology, and capital has reduced the relative labor input.

(3) We have increased dependence on international trade world wide. The U.S. has tripled our imports as well as our exports since 1965.

(4) We have the emergence of an international capital market that is well integrated into the economies of the world. International capital flows are ten times larger than international trade flows among countries.

(5) We have instability caused by changes in monetary and fiscal policies of leading world economies and secondary impacts resulting from the bloc-floating exchange rate policy.

(6) Finally, we have shifts in the underlying comparative advantage due to competition and development of resouces, technology and trade practices.

One implication of these external forces is that the major western nations have economies that are more open to global shocks from outside and less responsive to domestic policy decisions.

A second implication is that capital flows influence exchange rates more than trade flows and that swings in exchange rates may mask the real underlying comparative advantage.

The third implication is that the burden of adjustment falls disproportionately on trade sectors of the economy.

As a result, the external forces may change the underlying "economic reason for being" for many communities. An economic base may be radically expanded or contracted as we continue to open the U.S. economy up to a global economic shocks. This is particularly true for less-diversified communities with sectors sensitive to trade and global economic shocks.

INTERNAL FORCES AFFECTING MIDWESTERN COMMUNITIES.

Several internal forces are affecting midwestern communities and contribute to the future outlook of state and local government fiscal stability.

(1) Declining farm numbers have been a continuing trend for many midwestern communities. There is some debate on whether national farm numbers will stabilize or decline by half by the year 2000 (Smith, Edwards and Peterson). However, Iowa farm numbers have rather consistently declined by about 1,000 to 3,000 farms per year between 1970 and 1985--through the good years and poor years.

Absolute rate projections, while hazardous, show a 25 percent decline in Iowa farms by the year 2000--down from 113,000. Supporting this contention, the 1982 Iowa Agricultural Census indicated about 1.5 times as many farmers in the 45 to 65 age cohort as in the 25 to 45 age group. Under normal attrition, the younger group would replace the older group by the year 2000.

If the trend occurs, declining farm numbers will continue to change the complexion of many midwestern rural communities. While some economic diversification may occur, agriculture is likely to remain the major economic base for many communities.

(2) The reliance on nonfarm jobs has increased dramatically in rural communities. The ratio of rural nonfarm to rural farm population in the U.S. is approximately ten-to-one in the 1980s compared to one-to-one in the 1940s. However, there are more people living in rural America than ever before--61 million. The ratio may be twelve-to-one by the year 2000, but much depends upon the employment opportunities generated in rural areas.

(3) The population of the Midwest is aging. In 1985, Iowa ranked 3th among the states in percentage of its population over 65 years of age. It ranked first in the percentage over age 85. The percentage of the population over 65 is expected to increase from 14.3 percent to 17 percent by the year 2000.

Many rural communities have proportionately more senior citizens than the state average. Senior citizens possess different lifestyles and consumption patterns than other segments of society. They demand a different set of public services and have different health care needs compared to others.

(4) Declining school enrollment is continuing to occur in many communities due primarily to lower birth rates in the post baby-boom era. The Iowa Department of Education projects an average 4.7 percent enrollment decline by 1991. Twenty percent of the school districts are projected to lose more than 10 percent of their enrollment by 1991.

Iowa and many other midwestern states went through a round of school district consolidation in the 1950s and 1960s. However, either educational costs will rise or schools must be reconfigured in many districts to provide the same variety of courses and educational opportunity that is offered today.

One implication of the internal forces that are changing midwestern communities is that the demand for public goods and services will change, perhaps permanently, as the external and internal forces change the structure of the community.

A second implication is that as the demand changes, excess capacity may be created in some functions of government and shortages may develop in the provision of other public services.

As a result, fiscal stress may become manifested in a variety of local policy issues. Examples include taxation, school consolidation, road downgrading and abandonment, delivery of rural health care, social services and economic development.

LOCAL OPTIONS IN RESPONSE TO FISCAL STRESS

Local governments operate within the confines of state law. Therefore, the local options for dealing with fiscal stress are constrained by state lawmaking bodies. While every state has different laws, there are similarities in the general local options available.

In many cases fiscal stress will be alleviated by raising revenues, cutting spending or a combination of both. These decisions may often be compounded by limitations on raising certain revenues and mandated services without a funding accompaniment. As a result, many local governments have dramatically expanded the use of user fees and charges. At some point, if the degree of local fiscal flexibility continues to decline, either political pressure for change will likely grow or citizen interest in seeking local offices may decline.

Alternatively, fiscal stress may induce institutional innovation. Fiscal stress created by structural change in the community not only creates budgetary policy problems but also becomes manifested in a variety of public issues relating to provision of services. The underlying policy question raised is, "How should the functions of government be organized to efficiently provide the desired level and quality of services in the future?"

In response to this question, five basic options have been identified for local government officials confronted with limited budgets and choices on how to organize provision of public services. The conceptual model of options has been field-tested in Iowa and Kansas meetings with local leaders (Iowa Cooperative Extension Service; Kansas Agricultrual Experiment Station). The options are summarized below:

(1) CONTINUE THE PRESENT SYSTEM. If the community is faced with structural decline, per unit cost increases as present structure diverges from the optimal size economies and the quality of service may erode as the desired quality of service changes. The current fiscal trends might be reversed by economic development activities, however, that requires investment of time and resources with no guarantee for success.

(2) IMPROVE INTERNAL EFFICIENCY under the present system. Consolidate functions of various offices, such as the recorder, treasurer and auditor, into a more efficient organization and management style. Perhaps a centralized county executive office

patterned after the city manager and or corporate structure would be more efficient and responsive to the local policy board.

Responsibilities and activities of present staff may be redefined to achieve a more efficient utilization of resources. Computer and information skills and services may be increased to enhance productivity and/or reduce costs.

(3) FUNCTIONAL CONSOLIDATION. Consider consolidating specific functions of neighboring units of government to achieve more efficient economies of size. A variety of arrangements might be used to consolidate functions including contracting, sharing facilities, sharing personnel, joint activities and ventures, and full consolidation of the function. The distinguishing characteristic is that the policy-making body and other functions of each government unit remain separate.

(4) GEOGRAPHICAL CONSOLIDATION. This option involves consolidation of two or more similar units of government with neighboring geographical jurisdictions. School district consolidation and consolidation of counties are two examples. While this option is probably the most widely debated option it is probably the least used option.

(5) PRIVATIZATION. This option involves identification of those enterprises which might generate savings if they were to be contracted from the private profit or nonprofit institutions. This option also provides a means for developing new institutions to service certain functions of local government units on a regional basis, if merited by the economies of scale.

OBSERVED PATTERNS OF INSTITUTIONAL INNOVATION IN IOWA

Local government consolidation and privatization measures represent institutional innovations and usually would be expected to occur after significant structural shifts and changes in factor costs of local communities. Why? There are three reasons.

First, local government units have increasingly relied on intergovernmental aid to finance local government functions and generate a certain amount of local economic activity. In Iowa, about one-third of local government general revenues come from state and federal intergovernmental aid. So, there may be high economic and political costs associated with institutional innovations that may significantly reduce the inflow of dollars into the local economy.

Second, for an institutional innovation to occur, the benefits derived from new institutions must exceed the costs of establishing the new institution. The benefits from new institutions often accrue to a relative few while the costs may be perceived to affect larger numbers.

Finally, the rate of change in institutional innovation is determined by the marginal cost of mobilizing the economic and political resources needed to design the new institution (Deaton; Ruttan). So, if consolidation involves a time and resource consuming process, the rate of change is likely to be slow.

Since 1965, Iowa law has allowed contractual agreements among the various units of government, among government units and private agencies, and among the various government units to estabish new agencies. These agreements are to be reported to the Secretary of State, however, informal feedback from local officials show that a significant number of agreements are not reported. The data also include multi-year as well as annual agreements. Thus, the data understate the magnitude of number of total institutional innovations which occured (Table 1).

On the other hand, the authors believe that the sample may provide relative patterns of innovation by government function. Perhaps these patterns are also associated with the government functions where previous structures were obsolete relative to the present optimum economies of scale (Table 2).

The agreements have thus far been generally confined to larger SMSA counties. This implies that density of population may be important to generating sufficient returns from innovation. On the other hand, perhaps the relative economic and political costs of innovation are higher in the more rural counties in terms of loss of local control, relative loss of intergovernmental revenue, and loss of local identity.

As a result, significant consolidation activities have been and may continue to be slow to develop in rural areas with significant structural change in the economy. However, if the costs and returns to innovation can be altered by state government, perhaps innovation may be induced.

STATE OPTIONS IN RESPONSE TO FISCAL STRESS

Midwestern states have developed a variety of approaches for dealing with the fiscal stress of local communities. Here again many concepts are similar even though the specifics are different in each state.

(1) CHANGE LOCAL FISCAL LIMITATIONS. This option allows local government officials more flexiblity in raising local revenues, property taxes, and local option sales and income taxes. This may be accomplished by vesting more authority in

Table 1. Iowa 28E Agreements Registered by the Secretary of State, 1965-86.

YEAR	AGREEMENTS	YEAR	AGREEMENTS
1965	1	1976	117
1966	8	1977	137
1967	13	1978	146*
1968	12	1979	127
1969	9	1980	192
1970	12	1981	187
1971	28	1982	210
1972	44	1983	196
1973	64	1984	189
1974	65	1985	162
1975	117	1986	232

* Defined reporting categories changed.

Source: Iowa Secretary of State, 1987.

TABLE 2. Iowa 28E Agreements Registered by the Secretary of State By Function, 1986.

OBS.	Function	OBS.	Function
33	Law Enforcement	11	Education
26	Road Maintenance	9	Economic Development
26	Fire Protection	8	Corrections
22	Work Services	7	Transit
18	Utilities	6	Social Services
16	Health Services	4	Building
14	Housing Authority	3	Laboratory
14	Job Training	3	Communications

Source: Iowa Secretary of State, 1987.

local officials and reducing requirements for popular votes to increase tax revenues. However, this approach implies a reversal of recent trends toward more tax limitations.

The consequence of this option in communities with fiscal stress is that fiscal stress of the public sector is reduced by increasing the fiscal stress of the private sector. This approach also tends to foster a continuation of present institutions after significant structural change in the community has occurred.

(2) PROVIDE INTERGOVERNMENTAL AID. As income and consumption becomes more "uncoupled" from property intensive enterprises, perhaps there is a case for countinuing the tax mix shift from locally collected property taxes to state collected sales and income taxes. A variety of aid formulas are available including school aid, road aid and revenue sharing. However, these particular aid formulas do not provide aid based on community fiscal stress criteria.

Alternatively, local fiscal stress may be altered by providing significant property tax relief measures and/or property tax credits on state income tax returns for low income taxpayers. Most midwestern states employ both mechanisms.

Significant property tax relief measures may exacerbate local fiscal stress. If levy limits are not simaltaneously raised, the local public sector may face increased fiscal stress. If levy limits are raised, property tax relief for some may significantly shift the tax burden to other local taxpayers.

On the other hand, if property tax credits are used, fiscal stress may partially be alleviated for both the local private and public sectors. State revenues are used to lower the property taxpayer liability by the amount of the property tax credit. However, the local unit of government collects revenues that are greater than or equal to previous levels.

While most midwestern states possess property tax credit measures, only Minnesota and Michigan provide sizeable credits for a broad base of low income taxpayers (Gold). Since this mechanism can provide significant property taxpayer relief and reductions in fiscal stress at the same time, there may be future interest by states with income tax windfalls resulting from the Tax Reform Act of 1986. The property tax credit is a tool for shifting the tax mix from local property taxes to state income and sales tax sources.

Intergovernment aid may also be directly targeted to local government units based on fiscal stress criteria. States may identify programs associated with short-term or acute fiscal stress and increase the share of state aid revenues funding those targeted programs. Job retraining, food assistance, temporary housing, indigent health care are examples.

However, if the fiscal stress is due to major structural changes in the economy, perhaps broader economic development assistance initiatives based on more precise measures of local government fiscal stress are appropriate. Some states, such as Minnesota have defined criteria for "depressed communities" which qualifies certain communities for additional assistance.

If the depressed community criteria is set high few communities qualify. Those that do qualify are likely to be acutely affected by structural change. An example might include communites in the Minnesota Iron Range. If the depressed community criteria are set too low, most rural communities of the state may qualify. This may create destabilizing effects and fiscal stress for "nondepressed" communities or state coffers.

In contrast, other states such as Iowa have targeted part of their assistance toward "growth centers." This concept is based on the notion that perhaps the odds for success in creating jobs and employment are greater in communities where a critical mass of financial and business infrastructure already exists. Part of the problem in a less diversified state which faces structural change in agriculture is that perhaps 80 percent of the communities would qualify for "depressed community" status.

Politics must arrive at a solution to the age old debate of whether to help the growing communities to grow or to help the declining communities to fight the decline. The solution is typically a compromise which involves some of both.

As a result, if intergovernmental aid is used to reduce fiscal stress in "depressed" communities, it may become an innovation impediment which helps to preserve the status quo for a longer period than would have existed. This may be particularly true if the intergovernmental aid supports existing institutions.

On the other hand, intergovermental aid may be successful in expanding or diversifying the community economic base to alleviate the need for organizational change in local government functions. However, if economic development efforts are not successful, there may be a need for institutional innovations to be induced by state policy-making bodies.

(3) INDUCED INSTITUTIONAL INNOVATION. A variety of strategies may be used in combination to provide inducements for

institutional innovation. Generally the concepts are not dissimilar from business merger and consolidation literature (Porter; Harrigan). Institutional innovation may be induced by increasing the returns from innovation, increasing the costs of maintaining the status quo, and reducing the barriers for structural change.

Historically, many states have applied these principles to foster school district consolidation (Kohlmeyer). Here we explore the developing Iowa school restructuring issue to develop and apply the induced innovation concepts.

While there are many exceptions, opinion polls in one small school district showed that a sizeable portion of the parents favored consolidation as a means of improving the educational opportunity for their children. Many voters without children opposed school consolidation as a means of maintaining the local econonmy and provincial interests in the short-run. The school consolidation vote involved the following registered voters: 200 parents of school age children and 800 nonparent voters.

In this case, short-run community economics and provincial interests conflicted with long-term educational opportunity. In the long-run, however, the loss of a school may be the "straw that broke the camel's back" for the community. But, in most cases the community very likely lost it's economic reason for being long before the school closed. Therefore, "saving" the school alone, will not likely "save" a declining community.

RETURNS FROM CONSOLIDATION MAY BE INCREASED by increasing state aid to cover the transitional consolidation costs. However, a more direct impact may result if additional state aid were to be used to provide significant property tax relief for the voting residents of the consolidated districts.

In addition, many private and public sector consolidations fail due to opposition from management and staff. Perhaps income security or significant severance bonuses for terminated school administrators and staff would increase the returns from consolidation for key opposition.

INCREASING THE COSTS OF INACTION may take a variety of forms. Many states are raising minimum course offerings and minimum student numbers for accreditation. These standards are significant costs if accreditation is tied to state aid or continued operation.

Raising minimum and average teacher salaries may also significantly increase the costs of local inaction if state sources are not used to fully fund the raises. Requiring minimum standards for training and experience for courses and school functions may also lead to higher salaries in order to attract qualified individuals.

Finally, many states have considered giving parents of small schools the option to move their children and their funding base to another district. This may significantly increase the costs of inaction for a local school district.

REMOVING THE BARRIERS TO STRUCTURAL CHANGE have involved several proposals over the years. Voting rules may be relaxed to favor innovation. In particular, requiring a favorable majority of all combined districts for passage is less restrictive than requiring a majority in each of the districts. Several states relaxed school consolidation voting rules in the 1950s and 1960s.

Developing a process which allows objectors to option out of the consolidation plan turns potential opposition voters into supporters of consolidation. In Iowa, no school consolidation plans have been accepted in recent years without "letting out" some students to neighboring districts.

Incentives may be provided for sharing school administrators and specialized staff as a means of slowly reducing institutional innovation barriers and phasing in functional restructuring.

A final barrier to structrual change may be access to factual information. In the absence of facts, emotion and values are weighted more heavily in consolidation decisions. Because consolidations do not occur routinely, local expertise is not often available for conducting a feasibility study.

Business mergers often involve consulting firms to provide a disinterested appraisal of the alternative courses of action and technical possiblities for solving the issues that arise. In a similar fashion, many states have provided technical assistance in conducting local school consolidation studies.

The Iowa Department of Education conducts such studies upon local request and at zero cost to the districts. Such studies provide special expertise in program planning, curriculum, personnel, financing, facilities, bus routes, politics, and economic impacts. ISU Policy Specialists may also be asked to play a pre-feasiblity study educational role in some communities.

(4) MANDATORY CONSOLIDATION. Mandatory consolidation is an extreme form of induced innovation. The costs of inaction are made to be so high that no unit of local government could afford to ignore pursuing consolidation and institutional innovation.

However, in a democratic society, this approach has neither been generally acceptable nor is it often adopted without high political costs.

Even though the local schools which consolidate may generate significant returns from consolidation, on a statewide basis, the portion of pupils affected and savings is likely to be relatively small. If all of the small school districts in Iowa were consolidated to achieve the optimum economies of size, the statewide savings (statewide economic returns) would only represent two-tenths of one percent of the total educational costs in the state. While this implies nothing about changes in the quality of educational opportunity provided, the political costs for state lawmakers from mandatory consolidation may be high relative to the statewide economic returns.

(5) CONTINUE THE PRESENT SYSTEM. If the perceived costs are greater than the returns from inducing institutional innovation, continuing the present system may be the option selected in the short-run. State incentives for inducing institutional innovation may distort and overstate the actual underlying incentives created from small school inefficiencies or economies of size. If so, other state options may "prematurely" trigger consolidation.

Over the longer-term, if the structural change in the economy is broad enough to affect census redistricting, the balance of power in state legislatures will shift enough to lower the cost of institutional innovation in the future. Iowa school consolidation consultants predict that significant school consolidation will not occur in Iowa until after the 1992 legislative redistricting following the 1990 Census.

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